

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:MAN:1:POSTF-162153-01
JJSweeney

date: January 9, 2002

to: Patricia Chaback, Territory Manager 1150, Financial Services
Attn: [REDACTED], Revenue Agent, Team [REDACTED]

from: Area Counsel (LM:FS:MAN)

subject: [REDACTED]

EIN: [REDACTED]
POSTF-162153-01

This memorandum responds to your request for advice concerning your proposed adjustment to [REDACTED]'s ("the Bank") claimed interest expense deduction under Treasury Regulation Sec. 1.882-5 for the [REDACTED] and [REDACTED] tax years. In addressing your request, we outline below our understanding of the facts¹, the relevant law, your position, the Bank's position, and our view of the adjustment and its further development. For your proposed adjustment, we recommend that you issue an information document request based on the items listed on Attachment A to this memorandum. This issue was informally discussed with Chief Counsel International Branch 5. However, this advice is subject to National Office review. We will contact you within two weeks to discuss the National Office's comments, if any, about this advice.

Issue

Whether, based on the facts ascertained to date, the Service should adjust the Bank's claimed interest expense deductions for the [REDACTED] and [REDACTED] years by excluding from the Bank's computations under the branch book dollar pool method of Treasury Regulation Sec. 1.882-5, the liabilities and interest expense amounts booked in the Bank's [REDACTED] Branch.

Conclusion

[REDACTED], (b)(5)(AC)
[REDACTED]

¹The facts described herein were either obtained from information you submitted or from various financial publications.

(b)(5)(AC)

(b)(5)(AC)

Facts

The Bank's Businesses and Funding Sources

The Bank is a corporation organized under [REDACTED] law that maintains its home office in [REDACTED]. The Bank was owned by the [REDACTED] government until [REDACTED], when it was privatized.

As of [REDACTED], it was the [REDACTED] bank with reference to assets, maintaining over [REDACTED] branches in [REDACTED]. It also operates branches in the [REDACTED] and [REDACTED] and agencies in the [REDACTED]. Among its businesses, the Bank engages in retail banking, credit card transactions, and commercial lending. The Bank has significant amounts of assets and liabilities denominated in both [REDACTED] and U.S. dollars. In [REDACTED], some of its [REDACTED]-denominated loans were converted into Investment Units under a program initiated to protect [REDACTED] corporations from the devaluation of the [REDACTED] that occurred at the end of [REDACTED].

In [REDACTED], the Bank aggressively sought and obtained U.S.-dollar funding from various sources. It used [REDACTED]'s [REDACTED], which was organized to temporarily fund [REDACTED] Banks. By April [REDACTED], the Bank borrowed \$[REDACTED] from that facility, though this balance was repaid by [REDACTED]. The Bank issued commercial paper to obtain over \$[REDACTED] in U.S.-dollar funding that was to mature in [REDACTED]. This issuance was supported by a letter of credit provided by several unrelated Banks.

The Bank also raised over \$[REDACTED] in U.S.-dollar funding through the international capital markets. These funds were acquired through several private placements issued as asset-backed securities. The placements were issued through U.S. trusts and were secured by receivables due from credit card companies. In one placement, the Bank obtained \$[REDACTED] U.S. dollars through three-year debts priced at about [REDACTED] basis points above treasuries. In another placement, the Bank issued [REDACTED]-year U.S.-dollar bonds that

carried an [REDACTED] % interest rate. As a result of its [REDACTED] U.S.-dollar borrowing activities, by the end of [REDACTED], the Bank's U.S.-dollar liability book reached an average term of approximately [REDACTED] days.

[REDACTED]

The Bank's U.S. Agencies

The Bank operates in the United States through agencies located in [REDACTED]², [REDACTED], and [REDACTED] (referred to collectively as the "Agencies") and through subsidiaries organized in [REDACTED]. For the [REDACTED] year, the Agencies' assets consisted of loans to [REDACTED] corporations, [REDACTED] Securities, Bankers acceptances, loans to affiliates, and Federal Funds. Of those, the primary assets reported as generating U.S. effectively connected income for I.R.C. sec. 864 purposes ("U.S. ECI") were Treasuries and Federal Funds. The Bank classified its remaining assets as assets that produce U.S. non-effectively connected income ("U.S. non-ECI"). The major category of those remaining assets were loans to [REDACTED] borrowers. The Bank orally represents that those loans were negotiated by its [REDACTED] home office rather than by any of the Agencies.

The [REDACTED] Branch

The Bank maintains a branch located in [REDACTED] in the [REDACTED], referred to herein as "[REDACTED]". At year-end [REDACTED], [REDACTED] reported about \$[REDACTED] in assets. Of those, only about \$[REDACTED] in assets were purported to generate U.S. ECI³. Those assets were certificates of deposit, inter-bank

²The [REDACTED] operation was licensed as an agency by the [REDACTED] Department of Banking. Presumably the other U.S. agencies were licensed by their respective states.

³According to the Bank's workpapers, for its [REDACTED] interest deduction computation, the average [REDACTED] assets reported for Treas. Reg. Sec. 1.882-5 step 1 purposes as U.S. effectively connected assets was \$[REDACTED].

placements, and a portion of the Brady Bonds booked in [REDACTED].

The majority of [REDACTED]'s assets at year-end [REDACTED] were reported to generate U.S. non-ECI. Most of those such assets are loans to [REDACTED] borrowers. The Bank orally represents that its home office negotiated those loans. The reason for booking these assets in [REDACTED] is unclear. [REDACTED] also reported assets pertaining to what appears to be foreign exchange and other trading activities. Finally, [REDACTED] reported a \$[REDACTED] asset for amounts due from other Bank offices.

[REDACTED] reported approximately \$[REDACTED] in liabilities at year-end [REDACTED], consisting primarily of term debt (\$[REDACTED]), deposits (\$[REDACTED]), amounts due to other offices of the Bank (\$[REDACTED]), and other borrowings (\$[REDACTED]). A further breakdown of these liabilities shows the following average interest rates for some of them: [REDACTED]% on all deposits, including in that average [REDACTED]% on time deposits; [REDACTED]% on "loan repos"; and [REDACTED]% on "Other Borrowings". The remaining liability categories showed interest rates lower than these above-stated rates. It is unclear which of [REDACTED]'s liabilities are U.S.-dollar denominated.

The Agencies' role in operating [REDACTED] is unclear. The Bank orally represents that [REDACTED]'s assets and liabilities were managed by the Bank's home office in [REDACTED], yet it also states that the Agencies participated in negotiating all of [REDACTED]'s liabilities. You believe that [REDACTED] has no employees of its own, such that either the Agencies or another branch of the Bank must have been performing [REDACTED]'s activities.

The Bank's U.S. Interest Deductions

For the [REDACTED] and [REDACTED] years, the Bank used the branch book dollar pool method ("the Method") for determining its interest expense deductions under Treasury Regulation Sec. 1.882-5 ("Sec. 1.882-5"). In these computations, the Bank included as "liabilities shown on the books of the U.S. trade or business" all of the liabilities booked in [REDACTED]. Consistent with that position, it included in the Method all of the interest expense amounts associated with [REDACTED]'s liabilities. For [REDACTED], it reported the average interest rate on [REDACTED]'s liabilities as [REDACTED]%; for [REDACTED], it reported that rate as [REDACTED]%. You computed the average interest rate

on the Agencies' liabilities to be about █% for the █ year. We were not provided your computation of the Agencies' average interest rate for █.

When █'s liabilities are added to the Agencies' liabilities, the total amount exceeds the assets that the Bank reported in Step 1 of its interest computation for both █ and █. See, Treas. Reg. Sec. 1.882-5(b)(1). Given that situation, the Bank computed its interest deductions by multiplying its average U.S.-connected liabilities by the average rate on the liabilities of its U.S. business, which included those liabilities booked in █. Treas. Reg. Sec. 1.882-5(b)(3)(i). After computing its interest deductions, the Bank deferred portions of them for both years based on the requirements of I.R.C. Sec. 163(j).

After accounting for those deferrals, the Banks still reported net operating losses for both years. It also reported net operating losses for several tax years before █.

Law

For the █ and █ years, the Bank's interest expense deduction is determined based on Treasury Regulation Sec. 1.882-5 as promulgated in Treasury Decision 7749. 46 FR 1691. Sec. 1.882-5 prescribes a three-step formula for determining the interest expense deduction of a foreign taxpayer engaged in a U.S. trade or business. Step 1 requires a determination of the total average value of the foreign corporation's assets for the year that generate, have generated, or reasonable are expected to generate income, gain or loss effectively connected with the conduct of a U.S. trade or business. Treas. Reg. Sec. 1.882-5(b)(1). Step 2 requires the determination of the foreign corporation's U.S.-connected liabilities, with such liabilities based on either: (1) a fixed ratio, defined as 95% for a U.S. Banking, financing or similar business, or (2) an actual ratio, based on the average total amount of the foreign corporation's worldwide liabilities over the average total amount of its worldwide assets. Treas. Reg. Sec. 1.882-5(b)(2). Step 3 requires a determination of the interest rate(s) applicable to the foreign corporation's U.S.-connected liabilities determined in step 2. In this determination, a foreign corporation can elect to use either the branch book/dollar pool method or the separate currency pools method. Treas Reg. Sec. 1.882-5(b)(3).

For a foreign corporation electing the branch book/dollar pool method under Step 3, a determination is made of its average "U.S.-connected interest rate". To determine this rate, a foreign corporation must correctly identify the total amounts of interest expense and liabilities "shown on the books of [its] U.S. trade or business". The U.S. connected rate is based on the ratio of the interest expense amount to the liabilities so identified. If those liabilities exceed the U.S.-connected liabilities determined under Step 2, the interest deduction allowed is determined by multiplying the U.S. connected liabilities by the U.S.-connected interest rate.

If, however, the liabilities "shown on the books of the U.S. trade or business" do not exceed the U.S.-connected liabilities, the allowable deduction is the sum of (1) the total interest expense "shown on the books of the U.S. trade or business" and (2) the excess of the U.S.-connected liabilities over the liabilities "shown on the books of the U.S. trade or business" ("excess liabilities"), multiplied by the average interest rate on the foreign corporation's U.S.-dollar liabilities booked at its offices and branches outside the United States. If this rate cannot reasonably be determined, another method may be used that approximates that actual rate if such method is applied consistently from year to year.

Current Positions

The issue is whether the Bank correctly identified the interest expense and liabilities "shown on the books of [its] U.S. trade or business" in computing its U.S.-connected interest rate for Sec. 1.882-5 purposes.

You wish to adjust these [REDACTED] and [REDACTED] computations by removing from them all of the interest expense amounts and liabilities booked in [REDACTED]. You reason that because [REDACTED]'s liabilities were not booked by the Agencies, they must fail to qualify as "liabilities shown on the books of the U.S. trade or business" for Sec. 1.882-5 purposes⁴. In essence, you propose a "mechanical booking" test for determining these liabilities. To support this argument, you note that the Bank maintained separate books and records for

⁴This was the applicable standard under the Sec. 1.882-5 regulations issued in Treasury Decision 7748 on January 7, 1981. These regulations cover the [REDACTED] and [REDACTED] years at issue.

_____. You further note that for the _____ and _____ years the Agencies' audited financial statements exclude _____'s operations.

The Bank opposes your proposed adjustment on three grounds. First, it asserts that because the Agencies negotiated all of _____'s liabilities, they should be included in the Method based on the _____ proposed amendments to Sec. 1.882-5, which included a material participation test for determining such liabilities. Second, it asserts that because _____ funded the Bank's U.S. operations, _____'s liabilities should be considered part of the Bank's U.S. trade or business for Sec. 1.882-5 purposes. To support this argument they cite Private Letter Ruling 199917081, in which the Service ruled that the U.S. dollar liabilities of an offshore branch could be included in a foreign Bank's interest deduction computation. Finally, the Bank argues that even if _____'s liabilities are not considered liabilities of the Bank's U.S. trade or business, the proposed adjustment results in an excess of U.S.-connected liabilities over the liabilities of the Bank's U.S. trade or business in the _____ and _____ Step 3 computations under Sec. 1.882-5. See, Sec. 1.882-5(b)(3)(i)(B). The Bank then asserts that the interest rate applicable to the "excess liabilities" should be _____'s average borrowing rate. Under this final argument, adjustments reducing the interest expense deductions claimed for _____ and _____ would result, but for amounts less than from excluding the _____ liabilities in whole from the Method and then applying the Agencies' average borrowing rates to the "excess liabilities". Applying the Agencies' average borrowing rate to the "excess liabilities" is what you have tentatively proposed absent further information.

Analysis

Treasury Regulation § 1.882-5(b)(3) can be interpreted to impose a mechanical booking test, such that _____'s liabilities would fail to qualify as "liabilities shown on the books of the U.S. trade or business" because they were not booked in any of the Agencies. A mechanical booking test relies solely on determining where the liability was booked. It can be argued that Sec. 1.882-5 must have taken into account that foreign Banks typically establish branch operations under U.S. regulatory law as a base for their U.S. operations. It can further be argued that Sec. 1.882-5's labeling of the subject method as "branch/book dollar pool" evidences that U.S. liabilities were to be determined by

reference to those shown on the books of U.S. branches and agencies. Finally, it could be argued that Sec. 1.882-5 determines the interest rate on "excess liabilities" based on U.S.-dollar liabilities booked outside the U.S. because it was presumed that no such liabilities were includible in determining the U.S.-connected interest rate. Treas. Reg. Sec. 1.882-5(b)(3)(i)(B).

You have asserted grounds for concluding that the [REDACTED] liabilities were not booked in the U.S. A fact supporting that these liabilities were not booked in the Agencies is that [REDACTED] was excluded from the Agencies' books and financial statements. Another such fact is [REDACTED]'s own books and records, which appear to be separately determined. An additional supporting fact might be to show that [REDACTED]'s operations are excluded from reports issued to the Bank's U.S. regulators⁵.

As noted above, the Bank has argued for inclusion of the [REDACTED] liabilities by suggesting that the material participation test from the 1992 proposed regulations should apply. However, the material participation standard of the 1992 regulations is not binding as it was part of proposed regulations only. That standard was never adopted into any Final Sec. 1.882-5 Regulation. Moreover, even were these proposed regulations followed, the material participation standard was not the sole requirement for a liability to qualify as "properly reflected on the books of a U.S. trade or business"⁶. Prop. Treas. Reg. § 1.882-5(d)(iii). The Bank has not substantiated its compliance with these other requirements.

[REDACTED]
, (b)(5)(AWP)

⁵See this item on the attached proposed document request.

⁶The Proposed Regulations state that whether a liability is considered "properly booked" in the U.S. is a factual issue. Prop. Treas. Reg. Sec. 1.882-5(d). [REDACTED], (b)(5)(AWP)

[REDACTED] (b)(5)(AWP) One guideline is whether the liabilities' denominations approximately match the denominations of U.S. assets. Other guidelines would exclude liabilities not contemporaneously entered on the books of the U.S. business; banks' liabilities with high interest rates; and liabilities incurred in a trade or business conducted outside the U.S. We discuss some of these factors infra.

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⁷, (b)(5)(AWP)

⁸From reviewing the information provided, it appears that for the years at issue, [REDACTED]-denominated debts carried higher interest rates than those applicable to otherwise similar U.S.-dollar debts.

, (b)(5)(AWP)

, (b)(5)(AWP)

, (b)(5)(AC)

, (b)(5)(AC)

You have other potential support for rebutting the Bank's arguments. The Bank has not documented their allegations, such as those concerning their funding policies. The Bank's reliance on Private Letter Ruling 199917081 is overstated because that ruling was based on Sec. 1.882-5 as amended in

⁹Although you determined that for the [REDACTED] year [REDACTED]'s average interest rate substantially exceeded the Agencies' average rate, we are unclear whether that occurred for [REDACTED]. You should so verify for purposes of the above-recommended argument.

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, (b)(5)(AC)

Treasury Decision 8658 to include a new test for determining U.S. liabilities. Moreover, that ruling described an offshore branch wholly operated by a U.S. branch and whose sole purpose was to raise U.S.-dollar funding for transfer to the U.S. branch. The Bank has not substantiated such similar facts.

, (b)(5)(AC)

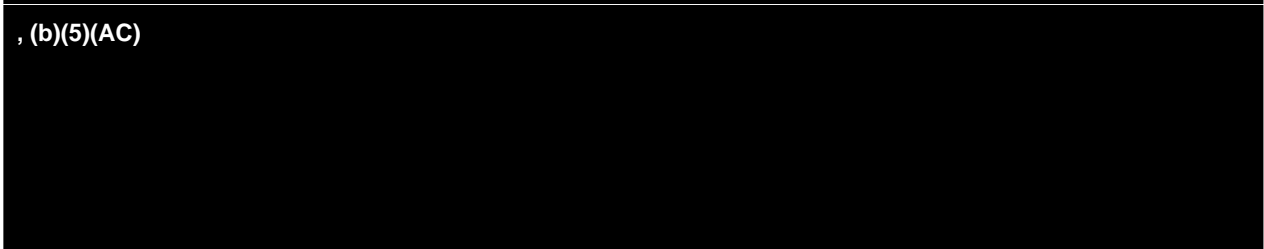
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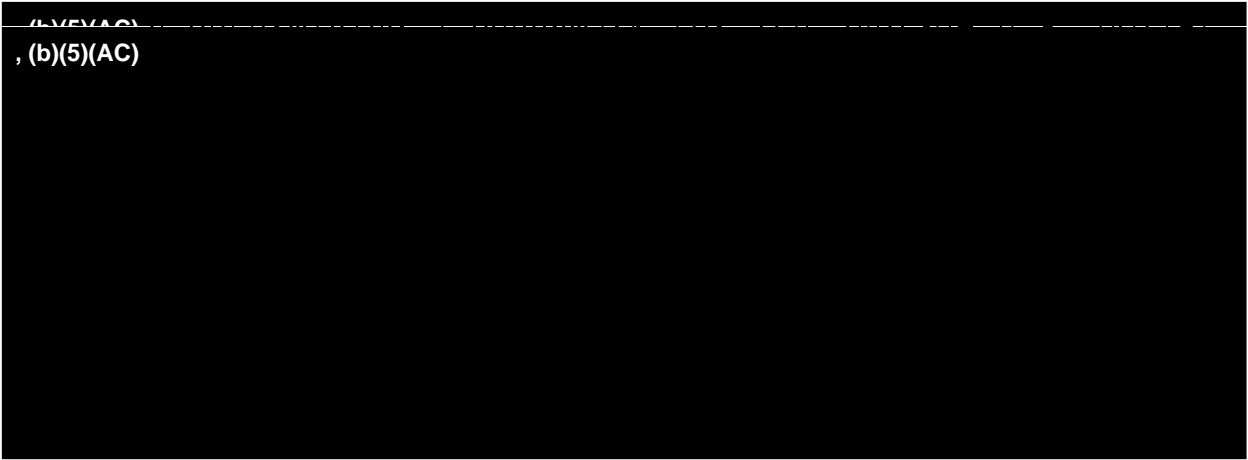
Sec. 1.882-5(b)(3)(i)(B) states that in determining this rate, the average interest rate on U.S.-dollar liabilities booked outside the U.S. should generally be used. It further states that if that rate cannot be reasonably determined, a taxpayer may use a method for determining the rate that reasonably approximates the actual rate if such method is applied consistently from year to year. On this matter, the Bank simply asserts that the average rate on [REDACTED]'s liabilities should be used for Sec. 1.882-5(b)(3)(i)(B) purposes.

Given the Bank's response, , (b)(5)(AC)

, (b)(5)(AC)



, (b)(5)(AC)



DISCLOSURE STATEMENT

This writing, including the attached proposed information request, may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

¹²On this point, we note that for the [REDACTED] year, the Bank elected the separate currency pool method and showed in its workpapers that its home office had booked U.S. dollar liabilities for that year.

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If you need to clarify any of the above recommendations, please contact John Sweeney at (212) 436-1452. You may contact him concerning any problems you have in securing or interpreting the documentation that we recommend you request. We will hold this case open for these purposes.

ROLAND BARRAL
Area Counsel (LM:FS)

By: _____
JOHN J. SWEENEY
Attorney

Enclosure: Attachment A

ATTACHMENT A

Sample Information Document Request

For purposes of these requests, any reference to "subsidiary records" should include general ledger and subsidiary ledger pages showing balances of referenced accounts and postings to such accounts that reflect journal entries affecting account balances. The references herein to "due to" and "due from" accounts refer to borrowings, loans, deposits and similar transactions between agencies, branches and other segments of [REDACTED] ("the Bank"). The reference to "[REDACTED]" refers to any branch, agency or other segment of the Bank organized under the laws of [REDACTED] and/or of [REDACTED], regardless of where its operations are conducted.

Please provide the following documents:

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